



Essential Utilities, Inc.

WTRG: M&A In Focus – Close Pending Wastewater Deals w/ New Ones Imminent

Overweight/\$47

Water Utilities

Price Target Change

• **Key Points.** WTRG reported solid Q3'20 results aided by higher residential water usage due to favorable weather and COVID has FY2020 EPS trending towards top end of the \$1.53-1.58 guidance range. In addition, management indicated roughly \$70M of additional tuck-in deals were expected to be announced by YE2020. For our part, we increase our 20E EPS accordingly to \$1.58 from \$1.56 and bump up our '22 & beyond M&A placeholder to \$75M/year of deals rather than \$60M given the continued positive momentum on that front. Our 2021-24E EPS of \$1.65, \$1.78, \$1.91 & \$2.03 reflects a mid-'21 DELCORA close and results in a 6.6% CAGR off the '19 base of \$1.47. If we were to strip out the DELCORA deal, it only has a modest \$0.03-0.05 impact (less than 3%) on our '22 & beyond EPS. We reiterate our Overweight rating and increase our 12-18 month price target to \$47/share (26.4X our 22E EPS) from \$45.

• **Water/Wastewater M&A Update.** In addition to getting the \$363M of pending deals closed (represents \$0.07 of incremental EPS power), management indicated a handful of new deals are expected to be announced by YE'20 representing \$70M of rate base and roughly 10,000 customers. Overall, WTRG is actively pursuing (i.e. having dialogue) municipal acquisition opportunities representing 360,000 customers, the majority of which are wastewater. Management expects the level of discussions/deals to be positively impacted by COVID as municipalities face additional financial and operational challenges and we remain optimistic that efforts could start to bear meaningful fruit in WTRG's states that have more recently adopted fair market value legislation (NC, OH, TX & VA) – we note that WTRG is the deepest-pocketed IOU in NC, OH & TX.

• **DELCORA – The Latest.** Much investor attention on the Q3 call was understandably on the pending \$277M DELCORA wastewater deal that is potentially at risk due to a court challenge by Delaware County's County Council. Hearings were recently completed on the legality of the trust aspect DELCORA's plan and the more important hearings related to the enforceability of the asset purchase agreement (does WTRG have a valid deal?) are expected in the next few weeks. A ruling from the judge in the Court of Common Pleas of Delaware County is expected within 60 days of the hearing. That said, the judge continues to encourage parties to reach a settlement. **While WTRG management was unable to confirm whether or not settlement discussions are taking place, the company remains confident in the ability to close the deal perhaps by late March or April.** This is consistent with the PaPUC approval process where evidentiary hearings are scheduled next week and the statutory deadline for a decision is 3/26/21. **(comments continue on p. 2.)**

	2019A	2020E	2021E	
\$ EPS		Curr. Prior	Curr. Prior	
Q1 (Mar.)	0.28	0.60 A	NC	NE
Q2 (June)	0.37	0.29 A	NC	NE
Q3 (Sep.)	0.48	0.23 A	0.20	NE
Q4 (Dec.)	0.34	0.46	0.47	NE
FY	1.47	1.58	1.56	1.65 NC
CY	1.47	1.58		1.65
FY P/EPS	28.0x	26.1x		25.0x
Rev.(MM)	890	1,931		2,052

Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters
 NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful
 V = Volatile
 Adjusted EPS excludes items considered non-recurring.
 WTR expects 2020 adjusted EPS at the top end of the \$1.53-1.58 range and targets a 5-7% EPS CAGR through 2022 off the 2019 adjusted base of \$1.47.

Ticker	WTRG
Price Target/Prior:	\$47/\$45
Price (11/04/2020)	\$41.19
52-Week Range:	\$30-55
Shares Outstanding: (MM)	245.2
Market Cap.: (MM)	\$10,099.8
S&P 500:	3,443.44
Avg. Daily Vol.:	1,162,150
Dividend/Yield:	\$1.00/2.4%
LT Debt: (MM)	\$5,277.4
LT Debt/Total Cap.:	53.2%
ROE:	9.0%
3-5 Yr. Est. Growth Rate:	6.0%
CY 2020 Est. P/EPS-to-Growth:	4.4x
Last Reporting Date:	11/03/2020
	After Close

NC = No Change

Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters

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Please see page 4 for rating definitions, important disclosures and required analyst certifications. All estimates/forecasts are as of 11/04/20 unless otherwise stated. 11/04/20 16:37:17 ET

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- **DELCORA – The Latest (continued...)**. While the DELCORA deal is highly supportive of WTRG's growth aspirations and management continues to express confidence in the ability to close the transaction, we consider the future to be bright without it driven by elevated pipeline infrastructure investment needs for the foreseeable future supplemented by water/wastewater municipal M&A trends. We believe relatively low risk, regulated EPS growth of at least 6% is achievable – that rate of growth would simply be enhanced if DELCORA closes, particularly in the later part of our 5-year forecast and beyond, given the \$700M of required investment needed in the system by 2028 as well as potential further municipal wastewater deals in the region.
- **Lower Makefield Township**. An agreement to acquire the 11,000 connection wastewater system in Bucks County, PA for \$53M was announced on 9/24. The deal is subject to PaPUC approval – which we expect will be received – and therefore closure probably is not likely until Q4'21. We view the deal as highly supportive of our EPS outlook as it essentially fills in our full year '21 M&A placeholder of \$60M.

Other Q3 Call Nuggets.

- **No Gas M&A** – Management made it clear that all M&A efforts are focused on the water/wastewater platform. No M&A expansion on the gas utility side is being contemplated. That said and despite gas utilities being largely out of favor with investors given anti-gas sentiment (existential threat?) in some parts of the country, management defended the Peoples deal and outlined the why the future is bright for the Western PA utility (and brighter than most other gas LDCs). We largely agree with management's arguments and our positive investment thesis and price target reflect it.
- **ESG** – Appealing to ESG investors/rating agencies is a priority. Management believes the company has made great strides in recent years with plans to further improve and therefore has a good story to tell. WTRG plans to establish credible, meaningful and attainable emissions reduction goals for Peoples within 6 months.
- **Peoples Repairs Tax** – No real updates on this front since WTRG filed in early August for PaPUC treatment of the catch up portion of the Peoples repairs tax deduction election. The filing outlined a \$381M catch up deduction and proposed to share the benefits between customers (40%, via a 2% bill surcredit over 2021-24) and shareholders (60%, via an increasing income tax expense offset over 2023-25). If approved, a base rate increase would not be needed prior to 1/1/2026 while supporting the elevated pace of capex deployment.

WTRG had communications with regulators and other key parties prior to making this filing which makes us hopeful that the proposal will be positively received and that a constructive outcome will ensue. The timing of a potential settlement could be before the evidentiary hearings in late January take place. Whether WTRG settles or the hearings occur and the proceeding is fully litigated, management believes a final decision is likely an early Q2'21 event.

Approval of the shareholder benefit aspect of the request would increase our confidence in the gas utilities' ability to achieve our forecast – we assume gas utility earned ROEs of 10-10.3% which we believe is reasonable and consistent with Peoples 2019 rate order. On the flip side, if the PaPUC decides to go a different direction with the catchup benefits, we still believe our 2023 & beyond EPS levels are reasonable within the backdrop of the constructive PA regulatory framework. It could simply necessitate filing for a base rate increase sooner which would bring with it associated regulatory risk.

Acronyms:

DELCORA – Delaware Country Regional Water Quality Control Authority

ESG – Environmental, Social, Governance

FMV – Fair Market Value

IOU – Investor Owned Utility

LDC – Local Distribution Company

PaPUC – Pennsylvania Public Utility Commission

Price Target

Price Target: \$47 from \$45

Our \$47/share price target reflects both a P/E multiple and DDM analysis. In terms of P/E, we apply a 70% water/30% gas utility hybrid multiple to our 2022E of \$1.78. For WTRG's water utility multiple, we ascribe a 5-10% discount to the 21E multiple we use for AWK (31.5-32X, which is a 5-10% premium to the pure play water peer group median). We consider AWK to be WTRG's closest peer on the water side based on scale, key states/regions and municipal consolidation strategies. The 5-10% discount reflects a modestly lower earnings growth rate (we forecast 6-7% for WTRG's water business vs. 8% for AWK) as well as lower ESG appeal (primarily due to the Peoples gas utility). For WTRG's gas utility multiple, we utilize the 21E pure play gas LDC median of 18X (based on ATO, NWN, OGS & SR) and then apply a 5-10% premium to it. We believe a premium is warranted as (1) Peoples is at the early stages of a multi-year accelerated pipeline replacement effort which is expected to drive healthy rate base growth for the foreseeable future (WTRG's 3-year guidance is 8-10%), (2) we believe Western PA, which sits above the prolific Marcellus and Utica shale plays, is largely immune to the anti-gas sentiment impacting some areas of the country and (3) most of Peoples falls under the constructive PA regulatory framework. Key risks relate to regulatory, Peoples gas deal integration and M&A strategy execution.

Investment Thesis

Our Overweight rating is premised on our belief that WTRG shares do not fully reflect the company's strong fundamentals which include a proven EPS growth strategy, a rate base that is growing at a mid-to-upper single digit CAGR, constructive regulatory treatment (particularly in PA where roughly 70% of earnings are derived and near-term regulatory risk is low as both the water and gas utilities completed rate cases in 2019), an efficient operating model and a solid financial profile. We believe relatively low risk, regulated EPS growth of at least 6% is achievable driven by the timely rate recognition of elevated pipeline infrastructure investment needs for the foreseeable future supplemented by water/wastewater municipal M&A trends.

Company Description

Headquartered in Bryn Mawr, PA, Essential Utilities (WTRG) - formerly Aqua America - is one of the largest U.S.-based investor-owned regulated water and wastewater utilities. The company serves approximately 3 million residents (1 million customer connections) in Pennsylvania, Ohio, North Carolina, Illinois, Texas, New Jersey, Indiana and Virginia. WTRG's largest subsidiary, Aqua Pennsylvania, accounts for approximately half of the company's total water customer base and nearly 70% of consolidated water rate base. Going forward, the company has expressed a desire to accelerate customer growth through a more active and focused acquisition strategy across its entire portfolio.

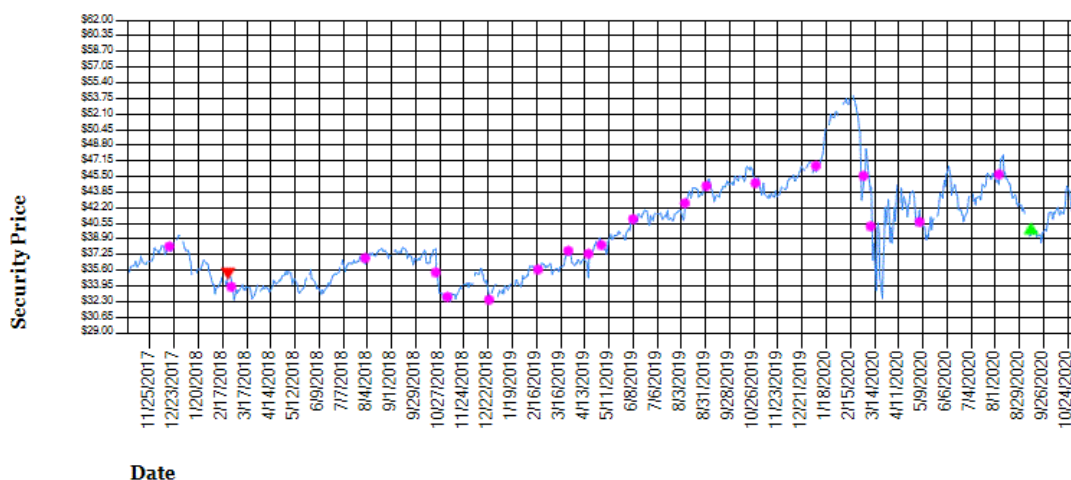
In March 2020, WTRG closed on the acquisition of Peoples - a predominately Pennsylvania-based gas utility serving 740k customers - from SteelRiver Infrastructure Partners for an enterprise value of \$4.275B (includes \$1.3B of assumed debt). From a price perspective, WTRG paid 1.9-2.0X rate base, 14.8X EV/EBITDA and nearly 25X P/E - lofty multiples but not that dissimilar to other gas utility transactions at the time. Management expects the deal to be EPS accretive in the first full year after close (2020) but stressed this is a strategic-driven, not synergy-driven, transaction.

Regulated operations account for more than 99% of consolidated revenues. Consolidated EPS is expected to be driven roughly 70% by water utility operations with the gas utility contributing the remaining 30%.

In February 2020, the new name Essential Utilities, Inc. and new ticker WTRG became effective. Prior, the company was known as Aqua America Inc. and traded under the ticker WTR.

Required Disclosures

Essential Utilities, Inc. (WTRG) 3-yr. Price Performance



Date	Published Price (\$)	Rating Code*	Price Target	Val. Rng. Low	Val. Rng. High	Close Price (\$)
10/30/2017		Reeder				
10/30/2017	NA	1	40	NE	NE	35.42
12/18/2017	38.14	1	43	NE	NE	38.03
2/25/2018	35.00	2	37	NE	NE	35.00
3/1/2018	34.19	2	36	NE	NE	33.66
8/2/2018	36.70	2	38	NE	NE	36.70
10/24/2018	35.01	2	37	NE	NE	35.29
11/6/2018	32.70	2	35	NE	NE	32.59
12/24/2018	33.87	2	34	NE	NE	32.38
2/19/2019	35.54	2	36	NE	NE	35.52
3/26/2019	37.52	2	39	NE	NE	37.52
4/18/2019	36.52	2	38	NE	NE	37.15
5/3/2019	37.85	2	39	NE	NE	38.09
6/9/2019	40.84	2	42	NE	NE	40.84
8/8/2019	42.06	2	44	NE	NE	42.47
9/2/2019	44.29	2	47	NE	NE	44.29
10/29/2019	44.90	2	46	NE	NE	44.68
1/8/2020	46.51	2	48	NE	NE	46.51
3/2/2020	43.01	2	45	NE	NE	45.44
3/11/2020	44.41	2	48	NE	NE	40.03
5/7/2020	40.49	2	42	NE	NE	40.53
8/6/2020	45.56	2	45	NE	NE	45.56
9/14/2020	39.35	1	45	NE	NE	39.82

*Effective December 7, 2019, Wells Fargo Securities' Equity Research modified its ratings definitions. Complete definitions of current ratings can be found below. For information related to prior ratings definitions, please contact equityresearch1@wellsfargo.com.

Source: Wells Fargo Securities, LLC estimates and Reuters data

Symbol Key

- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ◆ Price Target/Val Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- Analyst Change
- Split Adjustment

Rating Code Key

- 1 Overweight/Buy
- 2 Equal Weight/Hold
- 3 Underweight/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate

Additional Information Available Upon Request

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WTRG: Key risks relate to regulatory, Peoples gas deal integration and M&A strategy execution.

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1=Overweight: Total return on stock expected to be 10%+ over the next 12 months. BUY

2=Equal Weight: Total return on stock expected to be 0-10% over the next 12 months. HOLD

3=Underweight: Total return on stock expected to lag the Overweight- and Equal Weight-rated stocks within the analyst's coverage universe over the next 12 months. SELL

VOLATILITY RATING

V = A stock is defined as volatile if the stock price has fluctuated by +/-20% or greater in at least 8 of the past 24 months or if the analyst expects significant volatility. All IPO stocks are automatically rated volatile within the first 24 months of trading.

As of: November 4, 2020

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